

# Insurance Policy Rescission After a Claim is Filed: Bad Faith and Third-Party Claims

Recurring Issues for Insurers, Policyholders, and Innocent Third Parties

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# What is Rescission?

- An equitable remedy arising out of any contractual relationship.
- Based upon claim one party has been fraudulently induced to enter into contract.
- Or claim that one party made material misrepresentation to induce contract.
- Has its roots in English common law almost 1000 years ago.
- Relief is equitable because primary goal is not monetary but putting parties in status quo ante, as if the contract never existed, so all consideration is unwound and returned.

# Rescission of Insurance Policy

- Based upon alleged misrepresentation in an application for policy.
- Historically most common in applications for life insurance, but currently more prevalent in liability policies. (See *Stipcich v. Metropolitan Life Insurance Company*, 277 U. S. 311 (1928) “a failure by the insured to disclose conditions affecting the risk, of which he is aware, makes the contract voidable at the insurer’s option”).
- Applies to any type of insurance, liability, first party, personal or commercial lines, primary or excess, professional liability, workers compensation, title insurance, claims made/occurrence, etc.
- Can be based upon specific statutory requirements and/or common law decisions.

# Rescission of Insurance Policy (continued)

- Grounds for rescission most frequently but not necessarily discovered post-claim.
- Insurers can become aware of grounds for rescission, even without a claim, i.e. audit inspection of premium after policy is issued.
- When rescission may first become known before any claim is made under the policy, is it incumbent upon insurer to place insured on notice of rescission at that time, and take further action?

# Legal Elements of Cause of Action for Rescission

- A misrepresentation of a past or present fact.
- That is material to the decision to underwrite the risk.
- Reliance by the insurer on the alleged misrepresentation.
- Damages proximately caused by misrepresentation.
- There is no one-size-fits-all, as these basic criteria have nuances which vary from state to state.
- Most states engage in a “but for” analysis, i.e. but for the misrepresentation would the insurer have issued any policy, provided different coverage or lower limits and/or charged a higher premium.

# Legal Elements of Cause of Action for Rescission (continued)

- See *Scottsdale Indem. Co. v. Suncoast Gen Ins. Agency*, 2020 WL 8569410 (C.D. Cal. Dec. 21, 2020). *Curanovic v. New York Cent. Mut. Ins. Co.*, 762 N.Y.S. 2d 148 (3d Dept. 2003) & *United Auto Ins. Co. v. Salgado*, 22 So. 3d 594, 599 (Fla. 3d DCA 2009). Good summary of elements of rescission under California, New York & Florida law. (Materiality generally established if insurer may have increased premium or not issued the policy had it known of the misrepresentation).
- Some states define materiality by statute, e.g. New York Ins. Law § 3105(b)(1)

# Misrepresentation

- For insurance policies, misrepresentations are usually made in a written application for the policy, either by a direct incorrect answer or by omission.
- Must determine if jurisdiction requires negligent or intentional misrepresentation for rescission. See, by way of example Fla. Stat. § 627.409(1) N.Y. Ins. Law § 3105, Cal. Ins. Code § 359, Ala. Code 1975 § 27-14 to 28, Ga. Code Ann. § 33-24-7, ILCS 5/154, Mass. Gen. Laws Ann. 175 S .186, N.C.G.S.A. § 58-3-10, Va. Code Ann. § 38.2-309, Miss. Code Ann. § 83-9-11 & Wash. Rev. Code Ann. § 48.18.090 (1).

## Misrepresentation (continued)

- The vast majority of jurisdictions recognize rescission based upon innocent or negligent misrepresentations. There are a minority of states, like Connecticut, that require an intent to deceive. *Middlesex Mutual Assurance Co. v. Walsh*, 590 A. 2d 957 (Conn. 1991).
- Most states have some type of statute specifically pertaining to rescission of insurance policies, the exceptions being Colorado, Connecticut, Iowa, Missouri, New Jersey, Ohio and Pennsylvania.
- Must determine if the application question which is the subject of the potential misrepresentation is clear and unambiguous, i.e. is it capable of more than one reasonable interpretation. Is the question objective or subjective?

## Misrepresentation (continued)

- Courts generally apply concept of contra proferentum to insurance applications, just as they do to insurance policies i.e. the insurer is never going to get the benefit of any doubt about potential ambiguity in application question at issue.
- Must determine if misrepresentation was made directly by the insured or through an agent or broker and, therefore, whether or not the agent or broker's acts are attributable to the insured. *Georgia Casualty & Surety Co. v. Valley Wood, Inc.*, 336 Ga App. 795 (2016).
- If rescission is actionable in a given state for negligent or innocent misrepresentations, must determine if there is any policy provision which arguably excuses unintentional misrepresentations.

## Misrepresentation (continued)

- *MADvantage Ins. Co. of N.J. v. Hasiuk*, 2020 WL 1531817 (E.D. Pa. Mar. 31, 2020). Patient request for medical records insufficient to place insured physician on notice of potential claim or anticipated litigation.
- *But see, Certain Underwriters at Lloyd's London v. KG Admin Servs., Inc.*, 2019 WL 6770061 (N.D. Ohio Dec. 12, 2019). Failure to disclose pending lawsuits on application constituted misrepresentation.

# Materiality

- If an application question is answered falsely or incorrectly, would the underwriter have accepted or rejected the application if the correct or truthful information had been provided?
- *Atain Specialty Ins. Co. v. Like Lindero Homeowners Ass'n*, 2020 WL 7416169 (C.D. Cal, Nov. 25, 2020). Materiality is determined “solely by the probable and reasonable effect which truthful answers would have had upon the insurer.”
- If the correct or truthful response to a question had been provided, would the insurer have undertaken additional underwriting via a supplemental application or otherwise, and what would have been the outcome of that process?
- What are the insurer’s underwriting guidelines relating to the application question at issue?

## Materiality (continued)

- What are the insurer's underwriting practices relating to the question at issue? (If you have ever attended the deposition of an underwriter, you would immediately appreciate the distinction between guidelines and practices).
- Has the insurer made any exceptions in the past by providing coverage when an unfavorable response is given to the application question at issue? (This happens more frequently than one might expect, either based upon a concession to a business relationship with the retail broker or oversight by the underwriter).

## Materiality (continued)

- Can policy provisions impact materiality? Compare *Strickland Imports v. Underwriters at Lloyds, London*, 668 So.2d 251 (Fla. Dist. Ct. App. 1996) & *Admiral Ins. Co. v. Joy Contractors*, 19 N.Y. 3d 2012)

# Reliance & Damages

- Was the insurer's reliance upon a representation in the application reasonable or does it require verification or further investigation? *Ledley v. William Penn Life Ins Co.*, 138 N.J. 627 (1995).
- Does an insurer have a duty to investigate facts disclosed in application? *Indep. Fire Ins. Co. v. Arvidson*, 604 So. 2d 854, 859 (Fla. DCA 1992), *Koral Indus. v. Sec.-Conn. Life Ins. Co.*, 802 S.W. 2d 650, 651 (Tex. 1990) & *Philadelphia Indem. Ins. Co. v. Horowitz, Greener & Stengel, LLP*, 379 F. Supp. 2d 442, 454 (S.D.N.Y. 2005). . Does that potential duty depend upon the type of coverage provided, i.e. primary vs. excess?

## Reliance & Damages (continued)

- Damages in a rescission action are typically limited to the equitable relief of having the policy voided as if it never existed.
- There can also be monetary damages, particularly if an underlying claim has been defended pending judicial resolution of rescission.
- An insurer must reserve its rights to recoup attorneys' fees and defense expenses as part of providing a defense.

# Policyholder Defenses to Rescission

- Application question is ambiguous and, therefore, no misrepresentation. *American Policyholders Ins. Co. v. Portale*, 88 NJ Super. 429 (App. Div. 1965), overruled on other grounds, *State Farm v. Wall*, 92 NJ Super. 92 (1966), *Mercury Ins. Co. v. Markham*, 36 So.3d 730, 733 (Fla. Dist. Ct. App. 2010). *Vella v. Equitable Life Assurance Soc'y*, 887 F.2d 388, 392 (2d Cir. 1989).
- *Am. Alternative Ins. Corp. v. Warner*, 2020 WL 6204924 (N.D. Cal. Oct. 22, 2020). Misrepresentation by policyholder is subject to an “objective reasonable person” standard under California law. In this case, insured lawyers knew that they had “blown” the statute of limitations issue, but they had warned client of risks on the statute issue and client continued to do business with them even after it was aware of the malpractice.

# Policyholder Defenses to Rescission (continued)

- *Wallingford Grp. LLC v. Arch Ins. Co.*, 2020 WL 4464629 (D. Conn. May 11, 2020). Prior knowledge exclusion involved, which is substantively similar to the warranty question on most policy applications. Court applied a subjective-objective test. First, did policyholder have actual knowledge of the potential claim? Second, would a reasonable person expect that a suit might follow.
- Insurer waived rescission:
  - a. By failing to act promptly after having knowledge of grounds for rescission. *H.J. Heinz v. Starr Surplus Lines Insurance Company*, Case No. 16-1447, 2017 WL 108006 (3d Cir. Jan. 11, 2017), *Ballow Brasted O'Brien & Rusin P.C. v. Logan*, 435 F.3d 235, 239-40 (2d Cir. 2006).

## Policyholder Defenses to Rescission (continued)

- b. Compare *GuideOne Specialty Mut. Ins. Co. v. Congregation Adas Yereim*, 593 F. Supp. 2d 471, 484 (E. D. N. Y. 2009), (10 month delay after insurer had full knowledge of facts justifying rescission was unreasonable and resulted in waiver) with *Republic Ins. Co. v. Masters, Mates & Pilots Pension Plan*, 77 F.3d 48, 53 (2d Cir. 1996) (insurer's investigation of rescission for more than one year not unreasonable where evidence did not show it had full knowledge of facts, as opposed to mere allegations of facts justifying rescission).
- c. By continuing to accept premiums after knowing grounds for rescission.
- d. By canceling policy as of a future date or issuing a non-renewal notice. *Stein v. Sec. Mut. Ins. Co.*, 38 A.D.3d 977, 832 N.Y.S.2d 679, 681-82 (3d Dep't 2007)

# Policyholder Defenses to Rescission (continued)

- e. By failing to return premium. *Am. Gen. Life Ins. Co. v. Schoenthal Family LLC*, 555 F. 3d 1331 (11<sup>th</sup> Cir. 2019).
- f. By taking any action after it has knowledge of grounds for rescission inconsistent with rescission.
- Insurer's underwriting guidelines do not support basis for misrepresentation.
- Insurer's underwriting guidelines or practices do not establish materiality of misrepresentation.

# Policyholder Defenses to Rescission (continued)

- Insurer has previously made exceptions for type of risk relating to alleged misrepresentation.
- Can policyholder utilize policy provisions to contest rescission?
- Post-claim underwriting. *Reserve Life Ins. Co. v. McGee*, 444 So. 2d 803, 811 (Miss. 1983).

# What Insurers Should Consider if They Suspect Potential Grounds for Rescission on Receipt of Claim or Lawsuit

- Obtain and review application for policy to verify misrepresentation and clarity of questions and responses at issue.
- In many jurisdictions, the misrepresentation does not have to be related to the underlying claim or lawsuit, so that needs to be verified at the outset under applicable state law.
- Obtain and review underwriting file to determine if potential misrepresentations outside of the application itself were made during indication, quoting and binding portions of the underwriting process.
- Obtain and review applicable underwriting guidelines in place at the time the offending application was submitted.

# What Insurers Should Consider if They Suspect Potential Grounds for Rescission on Receipt of Claim or Lawsuit (continued)

- Identify and interview the underwriter, as she/he hold the keys to proving rescission
- Determine whether or not an agent or broker was involved in application process and the scope and extent of same. Does insured have an E&O claim and impact of same?
- Obtain copies of any agreements between/among insurers, insureds, wholesalers, program underwriters, retail brokers, agents.
- Determine if the acts of an insured's agent or retail broker in completing an application are binding upon the insured in the specific jurisdiction. See, for example, *Precision Auto Accessories v. Utica First Ins. Co.*, 52 A. D. 3d 1198 (4<sup>th</sup> Dept. 2008) & and *Gonzalez v. Great Oaks Casualty Ins. Co.*, 574 So. 2d 1182 (Fla. 3<sup>rd</sup> DCA 1991)

# What Insurers Should Consider if They Suspect Potential Grounds for Rescission on Receipt of Claim or Lawsuit (continued)

- If rescission is warranted, determine applicable state law and if it permits unilateral rescission, which could result in simply sending a letter to the insured with a return premium check, or if a judicial determination of entitlement to rescission is necessary.
- Determine if the jurisdiction requires interest on premium payments to be included with the return premium check.
- Determine if, as a primary third-party liability insurer with a defense obligation, the jurisdiction requires the insurer to provide a defense pending judicial resolution of rescission lawsuit.

# What Insurers Should Consider if they Suspect Potential Grounds for Rescission on Receipt of Claim or Lawsuit (continued)

- Coordinate with underwriting regarding return of premium and confirmation that no additional premium is collected and the policy not inadvertently renewed. Also, make sure that there is compliance with any applicable state insurance policy cancellation provisions, to the extent necessary. (Query. What if the premium is being financed?)
- If insurer is required to defend underlying claim pending judicial resolution of rescission under the law of the applicable jurisdiction (see for example *Federal Ins. Co. v. Kozlowski*, 18 A.D. 3d 33 (1<sup>st</sup> Dept. 2005)), it should reserve its rights to recover defense costs and attorneys' fees from insured if rescission is successful.

# What Insurers Should Consider if they Suspect Potential Grounds for Rescission on Receipt of Claim or Lawsuit (continued)

- Consider as an alternative remedy to rescission, for example, to affirm the contract and demand from or sue the insured for damages relating to the difference between the premiums paid and the additional premiums that should have been paid but for the misrepresentation. *Merchants Indemnity Corp. of New York v. Eggleston*, 37 N.J. 114 (1962).
- Determine if the jurisdiction whose law applies has as an alternative remedy, the possibility of using an application misrepresentation as a basis for disclaimer instead of rescission. See, for example, *Marchant v. Travelers Indemnity Co.*, 650 S.E. 2d 216 (Ga. Ct. App. 2007) and the Georgia rescission statute, O. C. G. A. § 33-24-7 (b)).

# Rescission and Bad Faith

- There is no specific body of case law regarding the application of bad faith to rescission actions.
- The same bad faith rules that apply in any jurisdiction in a coverage or disclaimer scenario apply equally when an insurer rescinds coverage.
- There are unique circumstances potentially created by rescission that could give rise to bad faith.
- In the third-party liability context, just as in any coverage case, there is the potential for bad faith if a primary insurer rescinds a policy post-claim:

## Rescission and Bad Faith (continued)

- a. Relating to an insurer's refusal to defend its insured, so it must be determined in any given jurisdiction at the outset whether or not a rescission is valid prior to a judicial determination that an insurer is entitled to rescission.
- b. There could be extra-contractual liability if there is a judgment in excess of policy limits against the insured, whether by jury verdict or consent judgment against the insured with an assignment of the insured's rights vs. insurer to plaintiff's counsel.
- In a first party policy, an insurer's rescission, if unsuccessful, could result in extra-contractual damages if the rescission has no justification. Also, must check potential applicability of state unfair claims practices statutes/regs.

# Rescission and Bad Faith (continued)

- Specifically related to rescission, insurers must be mindful of a particular jurisdiction's rules regarding cancellation and nonrenewal to make sure that even a fully justified rescission does not run afoul of some other statutory mandate.
- In those jurisdictions which allow it, if an insurer wrongfully rescinds a policy resulting in litigation with the insured, it could be responsible for the insured's attorney's fees for prosecuting or defending coverage litigation.

# Some One-Off Issues that Can Arise in Rescission Cases

- If there are multiple risks, such as separate insured locations under the same policy, but the misrepresentation only applies to one or more, but not the total number of locations, is partial rescission an available remedy? (In the few jurisdictions in which this issue has been addressed, it typically hinges upon whether or not the premiums for different risks/locations are divisible or just an aggregate) *United Auto Ins. Co. v. Reece*, 4 So.3d 80 (Fla. 3d DCA 2009) & *Garcia v. Government Employers Ins. Co.*, 151 A.D.3d 1020, 1022, 58 N.Y.S.2d 428 (2d Dept. 2017)

# Some One-Off Issues that Can Arise in Rescission Cases (continued)

- Impact of rescission on innocent insureds. (Occurs mainly in professional liability and D & O policies). See *Am. Guar. & Liab. Ins. Co. v. Jacques Admiralty Law Firm*, 121 Fed. Appx.573 (6<sup>th</sup> Cir. 2005); *DeMarco v. Stoddard*, 223 N.J. 363 (2015) (permitting rescission of professional malpractice policy).

# Some One-Off Issues that Can Arise in Rescission Cases (continued)

- Even if insurer is entitled to rescind as to its insured, it may still be required to indemnify the innocent plaintiff. This can occur with auto and workers compensation policies in which insurers are prohibited from rescinding because courts favor enforcing statutory schemes for compulsory insurance as a matter of public policy. *Capitol Indemnity Corp. v. Lowe*, 121 F. 3d 346 (10<sup>th</sup> Cir. 1998) (noting that although the term “compulsory insurance” is often applied to mandatory motor vehicle insurance it is not confined to that coverage).
- See *DeMarco v. Stoddard*, 223 N.J. 363 (2015) (not applying the innocent plaintiff rule to the rescission of compulsory medical malpractice insurance)

# Some One-Off Issues that Can Arise in Rescission Cases (continued)

*Zürich American Ins. Co. v. Whittier Properties, Inc.*, 356 F. 3d 1132 (9<sup>th</sup> Cir. 2004) (requiring insurer to indemnify innocent plaintiff under environmental liability policy despite material misrepresentation in the application because the EPA mandated the coverage).

- Rescinding policy and returning the premium prior to the filing of any claim or lawsuit.
- Policy provisions rendering policy non-rescindable.
- If the insured cashes the return premium check, does that constitute an acknowledgment and acceptance of the rescission?
- What happens if the insured does not cash the return premium check sent with a unilateral rescission notice letter? Is the policy rescinded?

# Some One-Off Issues that Can Arise in Rescission Cases (continued)

- Consider whether or not there is an independent, viable basis to disclaim coverage based upon an exclusion or other policy language to avoid rescission or as an alternative remedy.
- Consider, particularly with regard to a claims made policy, whether disclaimer of coverage or reservation of rights to disclaim is an option, in lieu of rescission based upon material misrepresentation in the application.
- Consider whether or not the application or policy has any potentially relevant and applicable warranty language, which has a body of statutory and case law all its own. See, for example, N.Y. Insurance Law § 3106.

## Some One-Off Issues that Can Arise in Rescission Cases (continued)

- Consider less drastic remedy of reformation in lieu of rescission if there has been a mutual mistake or a unilateral mistake accompanied by fraud or misrepresentation by the other party.
- Consider as part of a potential resolution strategy a payment to the insured in exchange for a buyback agreement of the policy, thus rendering the policy void.
- Rescission not applicable to innocent plaintiffs in cases in which insurance is required as a matter of public policy, such as auto insurance. *Citizens United Reciprocal Exchange v. Perez*, 432 N.J. Super. 526 (App. Div. 2013), or workers compensation insurance, *Aioss v. Sardo*, 249 N.Y. 270 (1928).

# Some One-Off Issues that Arise in Rescission Cases (continued)

- Post-loss misrepresentation resulting in rescission. *Longobardi v. Chubb Ins. Co. of NJ*, 121 N.J. 530 (1990).
- Does insurer have to investigate the truthfulness of responses in an insurance application?
- If an insurer successfully rescinds, can it recover damages for indemnity and defense expenses for claim at issue, and/or for other claims resolved prior to rescission.
- Consider the underwriting, misrepresentation and materiality ramifications of online application processes.

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